

Office of Chief Counsel
Internal Revenue Service

memorandum

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JEBudde

date: **JANUARY 19, 2001**

to: [REDACTED] Team Coordinator Columbus, Ohio
Attn: Robert Cozzarelli, IE

from: RICHARD E. TROGOLO
Associate Area Counsel (HMT)
Cincinnati, OH

subject: [REDACTED] Corp. EIN [REDACTED]
Section 304 computation for sale of [REDACTED], Ltd.

You recently requested our advice concerning the proper reporting of [REDACTED]'s sale of a foreign subsidiary, [REDACTED], Ltd., to [REDACTED] Corp., a related party.

Issue

When a domestic corporation sells a controlled foreign company which has two lower-tier foreign subsidiaries to a related domestic corporation in a transaction under Section 304 does the seller or the purchaser compute the foreign taxes deemed paid for the CFC and its subsidiaries?

Conclusion

Under the circumstances described below, the seller, [REDACTED], computes the foreign taxes deemed paid for the sale of the CFC. Any foreign taxes deemed paid by the CFC's two lower-tier subsidiaries are computed later when those subsidiaries distribute E & P to their shareholder.

Background

[REDACTED] was created by [REDACTED] in [REDACTED], was incorporated on [REDACTED], and before the events described herein was a publicly traded company. [REDACTED]'s businesses included the [REDACTED]

[REDACTED] expanded its business in the mid-[REDACTED]'s by acquiring almost [REDACTED] companies most of which featured [REDACTED]. This growth strategy eventually became counterproductive

_____ and the two subsidiaries had substantial amounts of foreign tax credits available to accompany any distributions of _____ Inc. had no use for the FTCs because it had substantial amounts of NOLs to carryforward. In contrast, _____ would be able to use all the FTCs. This disparate status provided the taxpayer an opportunity to plan the transaction to maximize the tax benefits, and it did.

Just prior to transferring _____ to _____ Corp., _____ distributed all of its stock (____%) in _____, Ltd. to _____. After the _____ distribution, _____ Inc. held ____% of the stock of _____. Soon thereafter, _____ Inc. sold the stock of _____ to _____ Corp.

_____ Inc. reported the sale of _____ on its _____ Form 1120 as follows:

Allocated Value of _____	
from mass appraisal	\$ _____
Closing Costs and Selling Fees	(_____)
Discount for ____% Expected Return	(_____)
Net Paid	\$ _____
Basis	_____
Net loss	\$ _____

The related-party loss was not recognized. Section 267.

_____ reported a dividend associated with the deemed distribution of the _____ E & P of \$ _____. _____ also received a deemed paid foreign tax credit of \$ _____. These two exhausted all the E & P and FTC of _____. The FTC could not be used by _____ Inc., because of its substantial losses. The acquiring company, _____, had no E & P as it was formed just prior to the sale.

The _____ subsidiaries, _____ and _____ had \$ _____ of E & P. None of this E & P was deemed distributed in _____ as a result of the subject transaction. In _____, the _____ subsidiaries distributed their E & P to their parent, who then upstreamed the dividends to the U.S. companies. With the dividends came substantial FTCs which _____ could use.

In _____ all _____ entities were sold to a third party for \$ _____. You note that this substantial increase in value over a relatively short time period calls into question the accuracy of the _____ appraisal and sale price. We

agree. [REDACTED] reported a 1248 dividend of \$ [REDACTED] (equal to the accumulated E & P at the sale date) and a deemed paid FTC of \$ [REDACTED] equal to the pool balance at the sale date. [REDACTED] also reported a capital gain of \$ [REDACTED] representing the CFC's appreciation in value over and above the 1248 dividend amount.

You have reviewed the transactions described above and have concluded that the [REDACTED] allocated value for [REDACTED] probably did not represent its arms length price. We advised you that to the extent the statute remains open for [REDACTED], you can challenge the reported amounts for that transaction under Section 482. See BTR Dunlop Holdings v. Commissioner, T.C. Memo 1999-377 (November 15, 1999); 1999 Tax Ct. Memo LEXIS 432; 78 T.C.M. (CCH) 797. If the [REDACTED] statute has expired, then you can reduce NOL carryforwards which are being applied to the to years in the current cycle for adjustments to [REDACTED], the NOL generating year. See Keefe v. Commissioner, 15 TC 947, 955-56 (1950) acq. 1951-1 CB 2; Rev. Rul. 74-61, 1974-1 C.B. 239; Rev. Rul. 81-88, 1981-11 I.R.B. 48 (March 16, 1981).

You advised us of the difficulties of revisiting the valuation issue for this virtually closed year. Instead, you have focused your attention on [REDACTED]'s reporting of the Section 304 distribution and the FTCs for [REDACTED] which enjoy a similar status as the NOL for purposes of the statute of limitations. We have reviewed the transaction and applicable statutes. We have found no clear error in the taxpayer's reporting of the transaction for [REDACTED]. In summary, the FTCs of the lower tier [REDACTED] subsidiaries do not get distributed to [REDACTED] Inc., the seller, in [REDACTED].

Analysis

The subject transaction took place between related parties, so the details must be carefully examined to insure their arms-length terms and accuracy in reporting. [REDACTED], the ultimate parent, owns all or almost all the stock in the buyer and the seller. Because the corporations have the same top level parent, the buyer and seller are deemed to "control" each other under Section 318. The transfer of the [REDACTED] stock gets taxed as a stock redemption instead of a sale. I.R.C. § 304.

Statutory Framework

In summary, Section 304, titled "Redemption through use of related corporations", mandates that certain transactions involving shares in related corporations be recast for tax purposes as redemptions, the tax treatment of which is then

governed by Section 302 and 303, and potentially Section 301. Specifically, Section 304(a) provides that if one or more persons are in control of each of two corporations, and in return for property, one of the corporations acquires stock in the other corporation from the person so in control, then such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock. Under Section 304(a)(2), which is titled "Amount Constituting Dividend", in any Section 304(a) stock acquisition, the amount of the dividend is determined by reference to two deemed transactions. The first is a deemed exchange of the target's stock for the purchaser's stock in a § 351(a) transaction and then the purchaser's redemption of its stock. The amount and source of the dividend is the acquiring corporation's E & P and then the issuing corporation's E & P.

Before Section 304(a)(1) applies, the transferor of the issuing corporation's stock must be in control of both the issuing and the acquiring corporations and the issuing corporation's stock must be transferred to the acquiring corporation in exchange for property, i.e., a "brother-sister" stock sale. Section 304(c)(1) specifies that "control" means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock." Section 304(c)(3)(A) further clarifies that "Section 318(a) (relating to constructive ownership of stock) shall apply for purposes of determining control under this Section". As a result, indirect ownership through partnerships, corporations, and other related entities is taken into account in ascertaining control. See Section 318(a).

The taxpayer contends that [REDACTED] Inc., the seller, is in control of both [REDACTED] -- the CFC, and [REDACTED] Corp. -- the purchaser. We agree. [REDACTED] Inc. held title to [REDACTED] % of the stock of [REDACTED] in [REDACTED] when it sold those shares to [REDACTED]. [REDACTED] Inc. also controlled [REDACTED] since they both have the same ultimate parent, [REDACTED] LLC. Although it was established as a LLC, Treas. Reg. § 301.7701-3 classifies these entities as corporations or partnerships. [REDACTED] LLC is a partnership for tax purposes, including for purposes of Section 318. [REDACTED] Inc. and [REDACTED] are owned by the same partnership.

The sale proceeds are treated as a dividend by the seller to the extent the acquiring corporation has E & P, and as a contribution to capital by the purchaser, the basis of which is determined by Section 362(a). Treas. Regs. §§ 1.304-1 and 1.304-2. Should the deemed dividend exhaust all the E & P of the

acquiring corporation, then the E & P of the issuing corporation would be used for dividend treatment. I.R.C. § 304(b)(2). We believe that the acquiring corporation [REDACTED] has little or no E & P available because it was formed shortly before the acquisition. The issuing corporation has approximately \$ [REDACTED] of E & P, and that amount was used and exhausted as part of the transaction.

Section 304(a)(1) requires an exchange of stock for property. Property is "money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock)." Section 317(a); Bhada v. Commissioner, 89 T.C. 959, 963-964 (1987), affd. 892 F.2d 39 (6th Cir. 1989).

Given the foregoing definitions of control and property, as well as the requirements for dividend treatment, we are satisfied that [REDACTED] Inc.'s sale of [REDACTED] to [REDACTED] is a transaction described by and taxed under Section 304(a)(1). With respect to control, [REDACTED] LLC directly owned [REDACTED] percent, or nearly [REDACTED]%, of the stock of both [REDACTED] Inc. and [REDACTED] Corp., before, during, and after the transfer. [REDACTED] Inc. and [REDACTED] are brother-sister corporations, and [REDACTED] Inc. controlled [REDACTED] before and after the transfer. Although [REDACTED] does business as a LLC, that status is disregarded for tax purposes. All LLCs are classified as partnerships or corporations. Treas. Reg. 301.7701-3. [REDACTED] is classified as a partnership. Consequently, Section 318 applies to it and mandates that [REDACTED] Inc. and [REDACTED] control each other.

As regards the next element, the exchange of stock for property, [REDACTED] Inc. transferred stock in [REDACTED] and received cash in return. Section 317(a) defines property as money, securities, and indebtedness in the corporation. Accordingly, the payment of cash for stock in [REDACTED] was a distribution of property within the meaning of Sections 317(a) and 304.

Section 302(b) provides some exceptions to the general rule whereby redemptions are treated as exchanges. Section 302(b)(1) states that redemptions "not equivalent to dividends" are excluded from treatment under 302(a) as a dividend. This exclusion does not apply to the [REDACTED] transaction. Redemption of the shares of a corporation's sole stockholder is "always" essentially equivalent to a dividend under Section 302(b)(1). United States v. Davis, 397 U.S. 301, 313 (1970) (taxpayer who under attribution rules was sole shareholder of corporation both before and after the redemption could not meet the Section 302(b)(1) test).

Section 302(b)(1) states that substantially disproportionate redemptions of stock are not subject to dividend treatment. This exception, like the (b)(4) Redemption from noncorporate shareholder in partial liquidation are obviously inapplicable and require no further discussion. Finally, because [REDACTED] Inc. is deemed to control the CFC both before and after the sale, there is no reduction in deemed ownership, which precludes the redemption from constituting a complete termination of [REDACTED] Inc.'s interest under Section 302(b)(3). Consequently, the [REDACTED] transaction is governed by Section 302(d) and, accordingly, that the tax effects thereof must be determined under Section 301.

Section 301, titled Distributions of Property, states a distribution of property (as defined in Section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c). Subsection (c), titled "Amount Taxable" -- states that in the case of a distribution under subsection (a), the amount constituting dividend -- i.e., that portion of the distribution which is a dividend (as defined in Section 316) shall be included in gross income. The amount distributed is the amount of money received, plus the fair market value of the other property received.

Section 316(a), in turn, defines "dividend" as "any distribution of property made by a corporation to its shareholders -- (1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits of the taxable year". In other words, a Section 301 distribution is taxed as a dividend, and therefore as ordinary income, to the extent of the distributing corporation's earnings and profits. Only after such earnings and profits are exhausted may the distribution be treated as a return of basis or capital gain.

Additionally, for purposes of applying the above test to a Section 304 redemption, Section 304(b)(2) specifies that the amount of the dividend shall be determined as if the property were distributed first by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation to the extent of its earnings and profits.

[REDACTED] Inc. the seller of the CFC has interpreted Sections 301 through 304, especially 304(a)(1) in a way that as so that only the top tier CFC was "acquired". There are no look-through rules in Section 304 which would trigger a redemption of the lower tier subsidiaries.

You point out that the issuing corporation, [REDACTED], is a holding company that distributed its operating assets to the

two lower-tier subsidiaries. Those lower tier subsidiaries also have substantial E & P and FTCs. You have asked whether the accumulated E & P of the lower tier subsidiaries is deemed distributed in the [REDACTED] transaction. We believe it is not distributed in [REDACTED].

Quite simply, Section 304 does not allow the computation of the amount of the dividend to extend to the E & P of subsidiaries of the issuing corporation. According to the sales agreement, [REDACTED] sold [REDACTED], and only [REDACTED], to [REDACTED]. [REDACTED] did not hold the stock of the two lower-tier [REDACTED] subsidiaries. [REDACTED] held that stock. Consequently, [REDACTED] could not have sold something it did not have. You ask if the sale of [REDACTED] includes a sale of the wholly owned subsidiaries of [REDACTED]. Unlike Section 1248, Section 304 contains no such "look-through" provisions. We have found no cases, TAMs, or FSAs which impute "look-through" rules for lower-tier subsidiaries. Absent an actual or deemed sale of the lower tier subsidiaries, we cannot include their E & P, and also, their FTCs in the computation of the E & P and FTCs of the parent when the parent is sold in a transaction taxed under Section 304. The Section 304(b)(2)(B) "issuing corporation" is [REDACTED], only, not the lower-tier subsidiaries. Under Section 304(a)(1)(B), only the stock of [REDACTED] is being redeemed.

Should you have any questions about this memo, please contact John E. Budde at 263-4857. A copy of this memorandum will be sent to the National office for 10 day post-review.

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By: _____
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